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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 450

MORRIS EISENBERG, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 451

HERMAN SCHAEFFER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 5-14) is not officially reported. The opinion of the Court of Appeals (R. 72) is reported at 174 F. 2d 827.

JURISDICTION

The judgments of the Court of Appeals were entered on May 9, 1949. (R. 73, 74.) The petition for rehearing was denied on August 16, 1949. (R. 82, 83.) The petition for certiorari was filed on November 9, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the Court of Appeals erred in affirming the Tax Court's finding that the taxpayers' respective children were not to be recognized as partners for federal income tax purposes.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [As amended by Section 1 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U.S.C. 1946 ed., Sec. 182.)

STATEMENT

The petitioners, Schaeffer and Eisenberg, have been associated in various retail enterprises since about 1920. (R. 6.) In 1930 Schaeffer opened four separate bank accounts, supposedly for each of his four children, but in his own name as trustee, there being no written trust instruments. In 1930 and 1931 Eisenberg opened precisely similar accounts for his three children. In October, 1936, the petitioners, as partners, started a retail business known as "Bailey's Furniture Company". During the next two years each petitioner withdrew about $25,000 from the bank accounts supposedly held in trust for his children,

which sums were used in the furniture business. (R. 6.)

On December 30, 1939, the taxpayers for the first time reduced to writing their partnership agreement, providing that the two would contribute all the assets to be used by Bailey's Furniture Co. and that the capital investment of each would be considered as $60,000. (R. 6-7.)

On January 2, 1940, Eisenberg created three and Schaeffer four separate irrevocable trusts for the benefit of their respective minor children; each executed several trust indentures, one for the benefit of each child, giving to himself as trustee various percentages of his interest in the business, totalling in each case one-half of his interest. (R. 7-8.) On the following day the petitioners, individually and as trustees, executed "addenda" to their articles of partnership which purported to make the trusts partners in the enterprise. (R. 9.) Thereafter, in proceedings involving the tax years 1940 and 1941, it was determined under the rule of *Helvering* v. *Clifford,* 309 U.S. 331, that the income of the trusts was taxable to the petitioners; no determination was made as to whether a genuine family partnership existed. *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C.A. 3), certiorari denied, 332 U.S. 767. The trust instruments were thereupon reformed in sundry respects and the wife of the taxpayer and another person—as to whose identity the

record is silent—substituted for the taxpayer as trustee in each case.[1] (R. 10-12.)

It is not contended that either the beneficiaries of the trusts or the substituted trustees ever contributed any services or participated in any way in the conduct of the business. (R. 13.) The business and its assets continued under the complete control of the taxpayers, and so far as appears from the record, its operation continued in all respects exactly as in the past.

The Commissioner, finding that the children were not partners in the furniture business for tax purposes, and that the entire earnings of that business consequently represented income to the petitioners, determined deficiencies in the petitioners' income tax for 1943 and 1944. The Tax Court held that no completed gifts of independent property had ever been made to the children or to the trusts created in their behalf and that none of them were valid partners in Bailey's Furniture Co. for federal income tax purposes.[2] (R.

[1] The terms of the reformed trust agreements are set out at R. 43-54.

[2] The taxpayers sought also to raise the issue whether, under the *Clifford* doctrine, income from the trusts, as reformed, was taxable to the grantors. The Tax Court's conclusion that all of the partnership income was attributable to the petitioners made it unnecessary to consider the *Clifford* issue, since as the Tax Court said, "The subsequent reformation of the 'trusts,' after the fathers had exercised their control by committing the funds to the business, whatever its legal efficacy, cannot alter this result as to the partnership, * * * regardless of what its effect might have been on the taxability of the trust income on purely *Clifford* grounds." (R. 14.)

12.) The Court of Appeals affirmed (R. 72) and denied petitions for rehearing (R. 82, 83.)

ARGUMENT

The reasons proposed for the granting of certiorari here are substantially the same as those asserted in *Kohl* v. *Commissioner,* 170 F. 2d 531 (C.A. 8th), certiorari denied, 337 U.S. 956, rehearing denied, October 10, 1949; *Fainblatt* v. *Commissioner,* 172 F. 2d 389 (C.A. 2d), certiorari denied, 337 U.S. 957, rehearing denied, October 10, 1949; *Moore* v. *Commissioner,* 170 F. 2d 191 (C.A. 4), certiorari denied, 337 U.S. 956, motion for leave to file petition for rehearing denied October 10, 1949. While the Tax Court here, as in the *Moore* case, appears to have relied on the absence of "capital originating" and "vital services" in determining that no valid partnership existed, no other conclusion could conceivably be reached under the principles enunciated in *Commissioner* v. *Culbertson,* 337 U.S. 733, were the case remanded to the Tax Court; it was presumably for this reason that the Court of Appeals denied the petition for rehearing filed subsequent to this Court's decision in the *Culbertson* case, and the simultaneous denials of certiorari in the *Moore, Fainblatt,* and *Kohl* cases.

Under the test laid down in the *Culbertson* case —i.e., whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise" (337 U.S. at 742)—it is apparent not only that

the Tax Court's conclusion that the children were not partners is not "clearly erroneous" but that no other conclusion could have been reached on the present record. The record reveals a persistent effort by the petitioners, commencing when the business began to show substantial profits,[3] to effectuate a tax saving by attributing some part of the income from it to some one other than themselves, without abandoning their substantial control and ownership of the business and its assets. The purported "partners" never contributed any services to the business, were never consulted as to its affairs, and did not in any respect participate in its management. The petitioners' substantial control of the business and its assets was uninterrupted.

Taxpayers contend, however, that their children made bona fide contributions to the business in that taxpayers withdrew and utilized in the business between 1936 and 1939 funds which they had deposited in savings bank accounts for their children in their own names as trustees in 1930 and 1931. It is undisputed that the use of the funds was not considered by taxpayers or the children to have been a contribution to capital at the time of the withdrawals; for it was not until 1940 that taxpayers purported to establish a partnership with the trusts for their children.

[3] In 1937 there was a loss; in 1938, a profit of $3,545.28; in 1939, a profit of $33,437.47; and in 1940, profits rose to $70,659.61 (R. 62-64). The partnership with the children was not established or even considered until the end of 1939.

(R. 61.) Moreover, the Tax Court found as a fact that no completed gifts were made to the children by virtue of the opening of the savings accounts.[4] (R. 12.) Certainly the form of the account without more does not compel or even permit the conclusion that there was in legal effect a declaration of trust or a completed gift. So far as the record discloses there was no express declaration of trust. No formal written instruments of trust were drawn in connection with the deposits; there was nothing to indicate that the beneficiaries had been notified; nor was there any delivery of the pass books. See 1 Bogert, *Trusts and Trustees,* par. 47, pp. 204-222. Most important is the fact that taxpayers at all times retained dominion and control over the funds, withdrew and utilized them for their own purposes in their own business and subjected them to commercial hazards in a manner inconsistent with a trust relationship. (R. 6.) Under such circumstances the Tax Court was justified in determining that taxpayers did not

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[4] This determination, it may be noted, is entirely in harmony with the law of Pennsylvania under which it is established that a trial court is justified in holding that no completed gifts have been made and no trusts established where depositors continue to exercise the absolute control and dominion of owners subsequent to the deposits.

In *Rambo* v. *Pile*, 220 Pa. 235, 241, the court stated:

> There is nothing in it to show an intention, on the part of the depositor, to hold the fund in trust, except the form of the deposit. All the circumstances surrounding the deposit tend to establish the fact that the deposit was made with the intention, on the part of the depositor, of retaining the control and ownership of the fund in himself and that he did exercise absolute control over the fund from its inception until the date of his death.

intend to relinquish control and ownership of the funds and that, there being no donative intent, as a matter of law no completed gifts had been made. In short, the working capital purportedly contributed by the children consisted of funds which the taxpayers had freely utilized in their business for the preceding four years and which, according to the Tax Court's finding, had never been given away. Moreover, apart from the theoretical powers of the trustees, the record shows that as a matter of fact none of the business profits were distributed to the children or to the trusts as partners subsequent to the formation of the partnership. (R. 61.) See *Commissioner* v. *Culbertson,* 337 U.S. 733, 747; *Hash* v. *Commissioner,* 152 F. 2d 722 (C.A. 4th), certiorari denied, 328 U.S. 838, rehearing denied, 328 U.S. 879; *Belcher* v. *Commissioner,* 162 F. 2d 974 (C.A. 5), certiorari denied, 332 U.S. 824.

If the taxpayers' children contributed nothing to the partnership, it is apparent that they were not partners. As this Court stated in the *Culbertson* case (pp. 739-740):

> To hold that "Individuals carrying on business in partnership" includes persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it. *Lucas* v. *Earl,* 281 U.S. 111 (1930); *Helvering* v. *Clifford,* 309 U.S. 331

(1940); *National Carbide Corp.* v. *Commissioner,* 336 U.S. 422 (1949).

CONCLUSION

The determination of the Court of Appeals rests on the particular facts of the case, is correct, and presents no conflict. The petition should be denied.

Respectfully submitted,

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